INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	2
Summary of Argument	6
Argument:	
Introduction	10
Federal tax liens on funds due a contractor from an owner have priority over subcontractors' statutory rights to payment which had not arisen when the federal lien came into existence and which, even after assertion, created only inchoate liens	11
A. Prior to the assertion of the subcontractors' "statutory right to payment," the United States had obtained an effective lien upon the property here involved, *i.e.*, the contractor's claim against the owners	11
B. The earlier tax lien of the United States has priority over the subsequently arising "statutory right to payment"	13
C. The contractor's claim against the owners did not cease to be property of the contractors (to which the federal tax lien attached) because the subcontractors could assert a "statutory right to payment" directly against the owners	15
D. Giving the subcontractors priority would result in extinguishing an existing federal lien through the rejected doctrine of "relation back"	24
Conclusion	26
Appendix	27

517028—59——1

CITATIONS

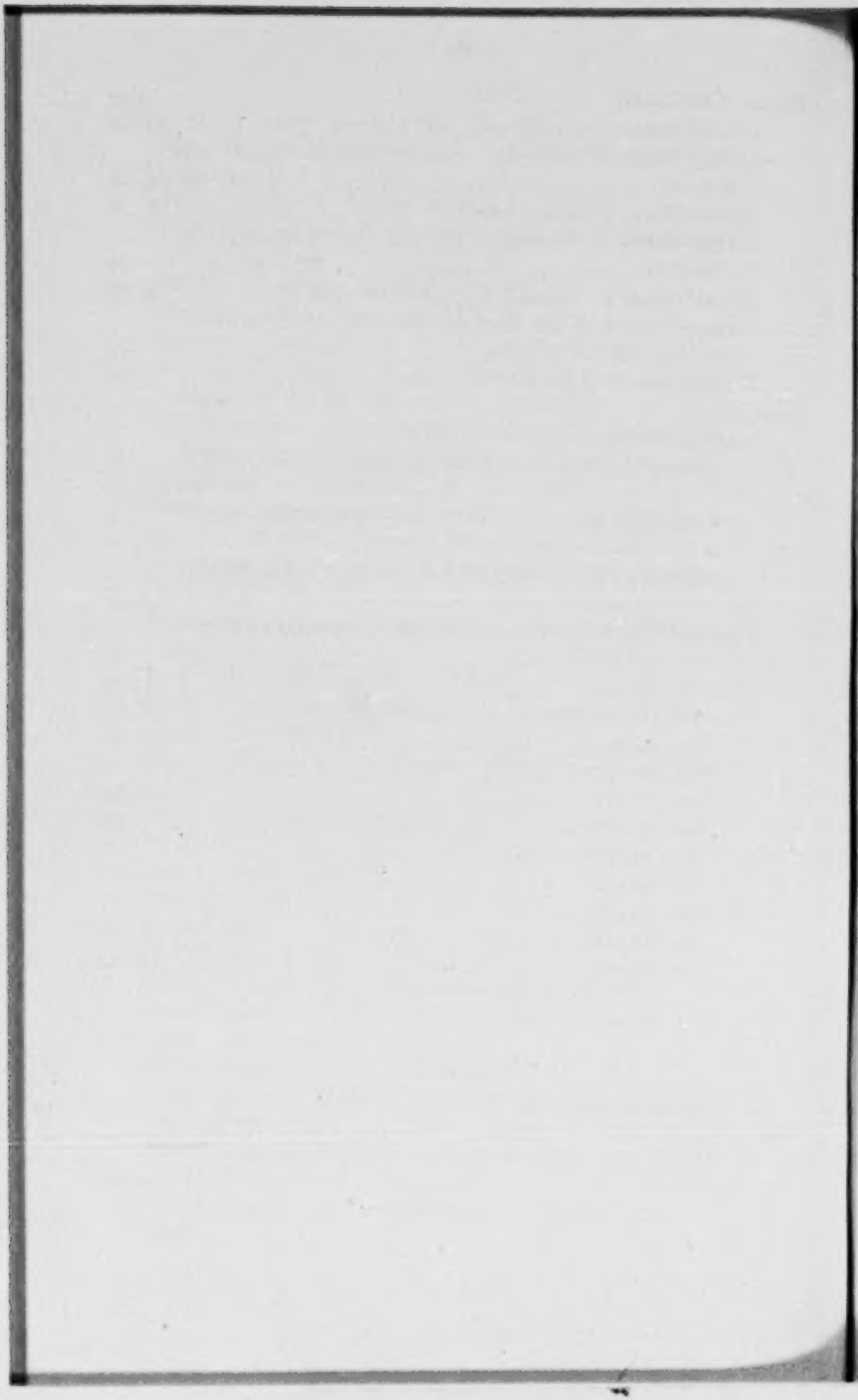
Cases:

	Page
Aquilino v. *United States*, 3 N.Y. 2d 511, certiorari granted, 359 U.S. 904	12, 13, 22, 23
Atlas Powder Co. v. *Denton*, 176 N.C. 426	20
Charlotte Pipe and Foundry Co. v. *Southern Aluminum Co.*, 172 N.C. 704	19
Clark v. *Edwards*, 119 N.C. 115	20
Commissioner v. *Stern*, 357 U.S. 39	25
Economy Pumps, Inc. v. *Woolworth Co.*, 220 N.C. 499	13
Fidelity & Deposit Co. v. *New York City Housing Auth.*, 241 F. 2d 142	23
Grier-Lowrance Construction Co. v. *Winston-Salem Journal Co.*, 198 N.C. 273	13
Hildebrand v. *Vanderbilt*, 147 N.C. 639	17
Illinois v. *Campbell*, 329 U.S. 362	15
Lester v. *Houston*, 101 N.C. 605	20
Morganton Hardware Co. v. *Morganton Graded Schools*, 151 N.C. 507	13, 19
Morganton Mfg. and Trading Co. v. *Andrews*, 165 N.C. 285	19
New York v. *Maclay*, 288 U.S. 290	25
Norfolk Building Supplies Co. v. *Elizabeth City Hospital Co.*, 176 N.C. 87	19
Orinoco Supply Co. v. *Eastern Star Home*, 163 N.C. 513	20
Payne v. *Flack*, 152 N.C. 600	20
Pinkston v. *Young*, 104 N.C. 102	20
Rose v. *Davis*, 188 N.C. 355	20
Schnepp v. *Richardson*, 222 N.C. 228	19, 20
United States v. *Acri*, 348 U.S. 211	15
United States v. *Bess*, 357 U.S. 51	13
United States v. *City of Greenville*, 118 F. 2d 963	14
United States v. *Colotta*, 350 U.S. 808, reversing 224 Miss. 33	14
United States v. *Gilbert Associates*, 345 U.S. 361	24
United States v. *Hulley*, 358 U.S. 66, reversing 102 So. 2d 599 (Fla.)	14
United States v. *Kings County Iron Works*, 224 F. 2d 232	12, 21, 22
United States v. *Liverpool & London Ins. Co.*, 348 U.S. 215	14, 15

COPY BOUND CLOSE IN CENTER

Cases—Continued

	Page
United States v. *New Britain*, 347 U.S. 81	7, 11, 12, 13, 15, 24
United States v. *Security Trust & Savings Bank*), 340 U.S. 47	7, 9, 14, 15, 24, 25
United States v. *Scovil*, 348 U.S. 218	14, 15, 24
United States v. *Vorreiter*, 355 U.S. 15, reversing 134 Col. 543	14
United States v. *Waddill Co.*, 323 U.S. 353	9, 23
United States v. *White Bear Brewing Co.*, 350 U.S. 1010, reversing 227 F. 2d 359	14
Widenhouse v. *Russ*, 234 N.C. 382	20
Statutes:	
Internal Revenue Code of 1954:	
Sec. 6321 (26 U.S.C. 1952 ed., Supp. V, Sec. 6321)	6, 11, 13, 27
Sec. 6322 (26 U.S.C. 1952 ed., Supp. V, Sec. 6322)	6, 12, 27
Sec. 6323 (26 U.S.C. 1952 ed., Supp., V, Sec. 6323)	9, 24, 27
General Statutes of North Carolina (Recompiled 1950):	
Sec. 44–1	28
Sec. 44–6	17, 28
Sec. 44–8	18, 29
Sec. 44–9	18, 29
Sec. 44–10	18, 30
Sec. 44–11	18, 30
Sec. 44–12	30
Sec. 44–38	31
Sec. 44–39	31
Sec. 44–40	31
Sec. 44–43	17, 32
Sec. 44–48	17, 32



COPY BOUND CLOSE IN CENTER

In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 23

UNITED STATES OF AMERICA, PETITIONER

v.

DURHAM LUMBER CO., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The memorandum opinion of the District Court (R. 13–14) is not reported. The opinion of the Court of Appeals (R. 30–38) is reported at 257 F. 2d 570.

JURISDICTION

The judgment of the Court of Appeals was entered July 18, 1958. (R. 39.) By order of the Chief Justice, dated October 10, 1958, the time for filing a petition for certiorari was extended to and including December 15, 1958. (R. 41.) The petition for certiorari was filed on December 15, 1958, and was

granted on February 24, 1959. (R. 42; 359 U.S. 905.) The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, in the distribution of a fund determined by a state court judgment to be owing to the taxpayer, a "statutory right to payment" arising under state law is entitled to priority over a federal tax lien which arose before the "statutory right to payment" came into existence.

STATUTES INVOLVED

Pertinent provisions of the Internal Revenue Code of 1954 and of the General Statutes of North Carolina are set forth in the Appendix, *infra*, pp. 27–32.

STATEMENT

This case arises from bankruptcy proceedings instituted in the United States District Court for the Middle District of North Carolina. It involves the relative priority of federal tax liens and the claims of certain subcontractors to a fund recovered by the trustee in bankruptcy as the balance due, under a construction contract, to the bankrupt general contractor who, in turn, is indebted to the United States for unpaid withholding and unemployment insurance taxes. (R. 11.) The undisputed facts may be summarized as follows:

The taxpayer-bankrupts, Michael and Embree, were general contractors engaged in business at Durham, North Carolina. During the first part of 1954, they entered into a contract for the construction of buildings for certain persons hereinafter referred to as the

COPY BOUND CLOSE IN CENTER

"owners." The construction was completed on July 15, 1954. (R. 7–8.)

Shortly thereafter, on August 13, 1954, and November 22, 1954, federal withholding and unemployment insurance taxes were assessed against the taxpayers in the amounts of $4,017.53 and $3,254.73, respectively. A notice of lien for the former amount was filed in the office of the Register of Deeds of Durham County, North Carolina, on November 2, 1954. (R. 9.)

Respondent Dixie Concrete and Supply Company, a subcontractor, gave notice to the owners on January 12, 1955, of its claim against the taxpayers for $3,089.54. Respondent Durham Lumber Company, another subcontractor, gave notice to the owners of its claim for $366.93 in February, 1955.[1] (R. 9.) Neither respondent brought suit within the six-months period provided by North Carolina law for foreclosure of mechanic's liens. (R. 37.)

On January 18, 1955, the taxpayers were adjudicated bankrupts in the United States District Court. At that time there was an unpaid balance of $5,250 due from the owners to the taxpayers under the construction contract. The owners disputed the amount, however, and contended that nothing was due. (R. 7–8.)

The trustee in bankruptcy instituted suit against the owners in the state court, and obtained a jury verdict for $5,250. Judgment on that verdict was entered on June 7, 1956. (R. 8.)

---

[1] A third subcontractor, Durham Brazing & Welding Company, gave notice of its claim to the owners on June 20, 1955. Five other subcontractors did not give notice to the owners. (R. 9.)

Shortly after this judgment was entered, the owners petitioned the bankruptcy court for permission to pay certain subcontractors of the bankrupts who had given the owners notice of their claims. Extensive negotiations were had among the trustee, the owners and the subcontractors, two of whom (Adams Concrete and Block Company ("Adams") and Nolan and Company ("Nolan")) had instituted suits against the owners in the state court. The owners filed a motion in the state court to reopen the proceedings brought by the trustees, in order to make the subcontractors parties to the action; and Nolan filed a petition in the District Court for permission to add the trustees in bankruptcy as a party to its action. Finally, under a compromise agreement approved by the District Court, the claims of Adams and Nolan were settled for a total of $465.65, with the understanding that this amount would be paid from the judgment obtained in the state court. The owners then paid to the trustees the judgment in the amount of $5,250, together with interest of $250. It was understood among the parties that their rights to this fund would be determined by the District Court in the same manner as if all parties were before the state court.[2] The Director of Internal Revenue was not a party to any of these proceedings. (R. 8–9, 10.)

---

[2] The judgment of the state court required the owners to pay to the trustee in bankruptcy the balance due on the construction contract, transferred the liens of the several claimants to the fund so paid and discharged the owners from liability to any of the liens claimants named as defendants in that proceeding. (R. 24–27.)

COPY BOUND CLOSE IN CENTER

The referee in bankruptcy determined that the fund should first be applied toward paying the fees of the trustees and their attorneys, court costs and the compromise settlement with Adams and Nolan, in the total amount of $1,885.65 (leaving a balance in the fund of $3,614.35) (R. 9–10). Second priority was given to the tax claims of the United States, on the ground that the federal tax liens were prior to those of the three subcontractors who had given notice to the owners (R. 10). The balance of $790 remaining in the bankrupt estate (which included assets in addition to the amounts received from the owners) after payment of the federal tax claims (R. 7) was ordered distributed *pro rata* to the three subcontractors who had given notice of their claims to the owners. The remaining subcontractors who had not given notice were held not to have any liens on the proceeds (R.10).

On exceptions filed by the two subcontractors who are respondents here, the district court held in a memorandum opinion (R. 13–14) that their liens were entitled to priority over the tax liens of the United States, and modified the referee's order accordingly.[2a]

The Court of Appeals for the Fourth Circuit affirmed the order of the district court. It stated that, under North Carolina law, the subcontractor who notifies the owner of his claim has both a lien on the real property, which is superior to any lien of the general contractor, and also a "statutory right to payment" from the owner (R. 34, 37); that although the

[2a] The effect of the modification was to allow these two claims in full, thereby reducing the amount received by the United States from $7,272.26 (the amount of its liens) to $4,606.79 (R. 7, 14).

517028—59——2

Government's tax lien "is clearly entitled to priority over the general claims of subcontractors seeking payment out of the property or interests in property of the general contractor, to which the tax lien has attached" (R. 34), the subcontractors here were not "seek[ing] payment out of the properties of the general contractor which are subject to the tax lien" but were presenting claims "addressed to the owners" (R. 35); and that the subcontractors' "statutory right to payment" by the owners "is not extinguished by the tax lien on the property of the general contractor, whose only claim against the owners under the laws of North Carolina, is for so much of the construction price as will remain unpaid after the owners have deducted a sum sufficient to pay the subcontractors" (R. 37–38).

SUMMARY OF ARGUMENT

A. Section 6321 of the Internal Revenue Code of 1954 provides that, upon failure of any person to pay any tax due to the United States, the amount thereof "shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." Section 6322 of the Code provides that the liens "shall arise at the time the assessment is made * * *." The federal taxes were assessed against the taxpayers-contractors on August 13, 1954 and November 22, 1954, and under Section 6322 the tax liens were perfected on those dates. At the time the liens were perfected, there was an unpaid balance of $5,250 due to the contractors from the owners. This indebtedness plainly constituted "property" or "rights to property" of the contractors within the meaning of Section 6321, and

COPY BOUND CLOSE IN CENTER

the federal tax lien attached to this claim against the owners. The subcontractors did not give notice to the owners until January and February 1955—several months after the federal liens had attached and more than two months after one of such liens had been recorded. Under North Carolina law, the subcontractors had no enforceable claim against the owners until they had given notice. Thus, the subcontractors' right to proceed directly against the owners did not arise until several months after the federal tax liens had attached.

B. In determining priority between liens of the same seniority, the settled rule is that "the first in time is the first in right." *United States* v. *New Britain,* 347 U.S. 81, 85. Thus, even if the subcontractors had obtained perfected liens upon the owners' indebtedness to the contractor when they gave notice (which they did not), the federal liens would still have priority.

Furthermore, it is well settled that a federal tax lien has priority over a mechanic's lien which, even though recorded, is still inchoate in the sense that additional steps are required to perfect it. *United States* v. *Security Trust and Savings Bank,* 340 U.S. 47. Here the subcontractors never obtained fully choate perfected liens. Prior to giving notice, they did not even have a "statutory right to payment," much less a perfected lien. Even after giving notice, their lien was still inchoate, since further steps were required to perfect it.

C. The Court of Appeals, although recognizing that a federal tax lien has priority over a mechanic's lien

"when the two liens attach to the same property" (R. 32), held that since the subcontractors had a "statutory right to payment" directly from the owners, the owners' indebtedness to the contractor ceased to be property of the latter to which the federal lien attached. While North Carolina law does give a subcontractor the right to proceed directly against an owner to enforce his lien, in doing so the subcontractor is merely seeking to apply the owner's existing debt to the contractor to the satisfaction of his own claim against the latter. Under North Carolina law the subcontractor has an enforceable claim against the owner only to the extent of the latter's indebtedness to the contractor at the time that notice is given. Thus, in asserting a statutory right to payment against the owner, the subcontractor necessarily stands in the shoes of, and claims through, the contractor. The North Carolina statutes merely provide a procedure by which the subcontractor can satisfy his claim against the contractor directly out of the latter's claim against the owner. The subcontractor is subrogated to the contractor's claim against the owner, and that claim continues to be "property" of the contractor even though state law permits such property to be applied directly to the discharge of the latter's debts.

The subcontractors' argument here is but another formulation of the view, repeatedly rejected by this Court, that by the mere existence of an inchoate lien upon a taxpayer's property, "such goods severed themselves from the general and free assets of the [taxpayer] from which the claims of the United

COPY BOUND CLOSE IN CENTER

States were entitled to priority". *United States* v. *Waddill Co.*, 323 U.S. 353, 358–359. For whenever priority is sought for inchoate local liens over existing federal liens, it can always be argued that the effect of the inchoate lien is to remove the assets to which it applies from the taxpayer's property. In Section 6323 of the Internal Revenue Code, however, Congress has made the decision that only four categories of lienors are specifically excepted from the priority of federal tax liens—mortgagees, pledgees, purchasers and judgment creditors—and then only with respect to unrecorded liens. Since the subcontractors' "statutory right to payment" had not been reduced to judgment prior to either the attachment of both federal liens or the recording of one of them Section 6323 is inapplicable here.

D. The effect of the decision below, therefore, is to treat the inchoate lien subsequently created by the giving of notice as relating back to a date prior to the creation of the federal lien. But "the doctrine of relation back * * * [cannot] operate to destroy the realities of the situation." *United States* v. *Security Trust & Savings Bank*, 340 U.S. 47, 50. The realities of the situation here are that, at the time the federal liens attached, the subcontractors had not yet asserted their "statutory right to payment" by giving notice, and the full balance due under the contract was owing to the contractor; that the right to receive such balance was property of the contractor to which the federal lien attached; and that, by giving notice, the subcontractors acquired only an inchoate lien, and

upon property which was already encumbered by the prior perfected federal liens.

ARGUMENT

INTRODUCTION

This Court has consistently held that federal tax liens have priority over mechanic's liens where the federal lien attached first or where, even if it arose after the mechanic's lien, the latter was "inchoate" in the sense that additional steps were required to perfect it (see *infra,* pp. 13–15). In the instant case, the federal liens arose several months before the subcontractors' "statutory right to payment" came into being, and at a time when any liens they may have had were still inchoate. Under these settled principles, therefore, it would seem beyond question that the federal tax liens have priority.

However, the Court of Appeals, although recognizing the "priority of the Federal tax lien over a mechanic's lien when the two liens attach to the same property" (R. 32), ruled that it was here "confronted with a different situation" (*ibid*). It stated (R. 34–35) that it could not "ignore the facts that the tax lien reaches the properties of the general contractor, not those of the owners, and that the independent rights of the subcontractors [their "statutory right to payment"] are asserted against the owners and their properties, not against the taxpayer or its properties"; and that the "priority of the tax lien" on the taxpayer's property "is not to be extended to a like priority in the division or distribution of the properties of the taxpayer's debtor to which the tax

COPY BOUND CLOSE IN CENTER

lien does not reach." In short, the Court of Appeals held that, since North Carolina law gives a subcontractor priority over a contractor in obtaining payment from the owner, the owner's indebtedness to the contractor is not part of the latter's property to which the federal tax lien attaches.

We shall show, however, that both the federal lien and the "statutory right to payment" do relate "to the same property," namely, the owner's indebtedness to the contractor; and that the federal lien attached to this property before the subcontractor's claim against it came into being. This case, therefore, is one to which the settled rule that "the first in time is the first in right" (*United States* v. *New Britain*, 347 U.S. 81, 85) is applicable. We shall further show that the prior lien of the United States upon this property was not extinguished by the subcontractors' subsequent assertion of their statutory rights to proceed directly against the owners to satisfy their claim against the contractor.

FEDERAL TAX LIENS ON FUNDS DUE A CONTRACTOR FROM AN OWNER HAVE PRIORITY OVER SUBCONTRACTORS' STATUTORY RIGHTS TO PAYMENT WHICH HAD NOT ARISEN WHEN THE FEDERAL LIEN CAME INTO EXISTENCE AND WHICH, EVEN AFTER ASSERTION, CREATED ONLY INCHOATE LIENS

A. Prior to the assertion of the subcontractors' "statutory right to payment," the United States had obtained an effective lien upon the property here involved, *i.e.*, the contractor's claim against the owners

Section 6321 of the Internal Revenue Code of 1954 (Appendix, *infra*, p. 27) provides that if any person

liable to pay any tax neglects or refuses to pay such tax after demand, the amount thereof (together with any additions thereto) "shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." Section 6322 (Appendix, *infra*, p. 27) provides that, unless another date is specifically fixed by law, the lien "shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed is satisfied or becomes unenforceable by reason of lapse of time." The federal taxes were assessed against the taxpayers on August 13, 1954 and November 22, 1954, respectively, and under Section 6322 the federal tax liens were "perfected" (*United States* v. *New Britain*, 347 U.S. 81, 84) on those dates.

At the time these liens arose, the construction work under the contract had been completed, and there was an unpaid balance due the contractor of $5,250. The fact that the owners disputed that this sum was owing is immaterial, for the subsequent state court judgment obtained by the trustee in bankruptcy against the owners conclusively established the indebtedness.

Under Section 6321 of the Code, the tax liens attached to "all property and rights to property, whether real or personal, belonging to" the taxpayers-contractors. Plainly, the existing indebtedness of the owners to the contractor constituted "property" or "rights to property" of the latter, and the lien therefore attached to the contractors' claim to this indebtedness. *United States* v. *Kings County Iron Works*, 224 F. 2d 232 (C.A. 2); *Aquilino* v. *United States*, 3 N.Y.

COPY BOUND CLOSE IN CENTER

2d 511, pending on writ of certiorari, No. 1, this Term; cf. *United States* v. *Bess*, 357 U.S. 51, 56.

The subcontractors did not give notice to the owners until January and February, 1955—several months after the federal liens had attached and more than two months after one of such liens had been recorded. It is settled, as the Court of Appeals recognized (R. 34), that under North Carolina law the subcontractors had no enforceable claim against either the owners or the real estate until they had given notice. *Grier-Lowrance Construction Co.* v. *Winston-Salem Journal Co.*, 198 N.C. 273; *Morganton Hardware Co.* v. *Morganton Graded Schools*, 151 N.C. 507; *Economy Pumps, Inc.* v. *Woolworth Co.*, 220 N.C. 499. Thus, however one may characterize the rights which North Carolina law gives subcontractors to proceed directly against the owners (see *infra*, pp. 17–23), it is undisputed that such rights did not here arise until several months after the federal tax liens had attached.

B. The earlier tax lien of the United States has priority over the subsequently arising "statutory right to payment"

1. In determining priority between liens of the same seniority, the settled rule is that "the first in time is the first in right." *United States* v. *New Britain*, 347 U.S. 81, 85. "Congress had this cardinal rule in mind when it enacted § 3670 [now Section 6321 of the 1954 Code], a schedule of priority not being set forth therein. Thus, the priority of each * * * lien contested here must depend on the time it attached to the property in question and became choate" (*id.*, p. 86).

As noted, the federal tax liens arose in August and November, 1954, and the subcontractors' "statutory right to payment" was not even asserted until January and February of the following year, when they first gave notice of their claims to the owners. Thus, even if the subcontractors had obtained fully perfected liens on the owners' indebtedness to the contractor by giving notice (which they did not, see *infra*, p. 15), such liens would still be subordinate to those of the United States under the settled principle that "the first in time is the first in right." *United States* v. *Hulley*, 358 U.S. 66, summarily reversing 102 So. 2d 599 (Fla.) (federal tax lien has priority over subsequently arising mechanic's lien); cf. *United States* v. *Scovil*, 348 U.S. 218; *United States* v. *City of Greenville*, 118 F. 2d 963, 966 (C.A. 4).

2. Even where the mechanic's lien was recorded before the federal lien arose, the federal lien has priority if additional steps are necessary to perfect the mechanic's lien. *United States* v. *Security Trust & Savings Bank*, 340 U.S. 47; *United States* v. *Colotta*, 350 U.S. 808, summarily reversing 224 Miss. 33; *United States* v. *White Bear Brewing Co.*, 350 U.S. 1010, summarily reversing 227 F. 2d 359 (C.A. 7th); *United States* v. *Vorreiter*, 355 U.S. 15, summarily reversing 134 Col. 543. The rationale of this rule, as explained in the *Security Trust* case, is that the effect of a local statutory lien in relation to the federal tax lien is always a federal question; that a prior inchoate lien under state law cannot take preference over a subsequent federal tax lien; and that the local lien remains inchoate, and unperfected in

COPY BOUND CLOSE IN CENTER

this sense, while it is "contingent upon taking subsequent steps for enforcing it" (340 U.S., p. 51). This rationale was reaffirmed in *United States* v. *Acri,* 348 U.S. 211 (attachment lien), *United States* v. *Liverpool & London Ins. Co.,* 348 U.S. 215 (garnishment lien), and *United States* v. *Scovil,* 348 U.S. 218 (landlord's distress lien), where the federal lien was held to have priority. See also *United States* v. *New Britain,* 347 U.S. 81, 86.

In the instant case, it is clear that the subcontractors never obtained fully choate perfected liens on the owners' indebtedness to the contractor. Prior to giving notice, they did not even have a "statutory right to payment" (see *supra,* p. 13), much less a perfected lien. Even after giving notice, their lien was still inchoate, since further steps were necessary to perfect it. The subcontractors had to initiate and successfully prosecute an action based on their "statutory right to payment," and the amount of such payment had to be fixed.[3] Cf. *Illinois* v. *Campbell,* 329 U.S. 362, 375; *United States* v. *New Britain,* 347 U.S. 81, 86. Their interest, therefore, was no greater than the other inchoate liens which have been held subordinate to federal tax liens (*supra,* pp. 14–15).

C. The contractor's claim against the owners did not cease to be property of the contractor (to which the federal tax lien

[3] In any suit by the subcontractors against the owners, the latter could have asserted any defense they might have as against the contractors (see *infra,* pp. 19–20). Indeed, in this very case the owners denied any liability to the contractors for the balance due—a claim which the state court rejected (see *supra,* p. 3).

attached) because the subcontractors could assert a "statutory right to payment" directly against the owners

The only theory upon which the subcontractors could have priority over the federal tax lien is that the mere existence of their inchoate "statutory right to payment" converted the contractor's claim against the owners into a direct obligation by the latter to the subcontractors; and that the contractor's claim, therefore, ceased to be "property" of the contractor to which the federal lien could attach. This, apparently, was the view of the Court of Appeals. It stated (R. 34, 35) that "the independent rights of the subcontractors are asserted against the owners and their properties, not against the taxpayer or its properties * * * the subcontractors here * * * do not seek payment out of the properties of the general contractor which are subject to the tax lien. Their claims are addressed to the owners."[4]

We shall show, however, that the North Carolina "statutory right to payment" is not an "independent cause of action against the owner" in the sense that in asserting it the subcontractors "do not claim through or in the right of the taxpayer" (R. 34, 35). It is a method by which the owner's indebtedness to the contractor is applied to satisfy the latter's indebtedness to the subcontractors. Since the "statutory right to payment" exists only to the extent that

[4] See, also, the court's statement (R. 37–38) that the contractor's "only claim against the owners under the laws of North Carolina, is for so much of the construction price as will remain unpaid after the owners have deducted a sum sufficient to pay the subcontractors."

COPY BOUND CLOSE IN CENTER

the contractor has an enforceable claim against the owner (see *infra,* pp. 19–20), the subcontractors necessarily stand in the shoes of, and claim through, the former. Their position basically is that of subrogees of the contractor's claim against the owners, and that claim is just as much "property" of the contractor as any other chose in action.

1. Under North Carolina law, all subcontractors furnishing labor or material for building, repairing or altering houses shall, upon giving notice to the owner of the property, "have a lien on said house and real estate for the amount of such labor done or material furnished * * * which may be enforced as other liens in this chapter" (Section 44–6, Appendix, *infra,* p. 28). This lien on the realty, however, "is extinguished if the subcontractor does not commence an action to enforce it within six months after the notice * * *" (R. 33; Section 44–43, 44–48(4), Appendix, *infra,* p. 32; *Hildebrand* v. *Vanderbilt,* 147 N.C. 639). In this case, no action to enforce their liens on the realty was brought by the subcontractors within six months of giving notice, and those liens were therefore extinguished.

North Carolina law further provides for satisfaction of the subcontractors' claims against the contractor out of the owner's indebtedness to the latter. The contractor has the "duty * * * before receiving any part of the contract price, as it may become due," to furnish the owner with an itemized statement of any amounts due to subcontractors; upon the delivery of such statement "it is the duty of the owner to retain from the money then due the contractor a sum not

exceeding the price contracted for, which will be sufficient to pay" such subcontractors, and which amount "the owner shall pay directly" to the latter (Section 44–8, Appendix, *infra,* p. 29). Furthermore, the subcontractor himself may give notice of his claim by giving the owner an itemized statement (Section 44–9, Appendix, *infra,* pp. 29–30). If, upon giving of such notice, the owner refuses to retain, "out of the amount due the contractor under the contract," a sum sufficient to pay the subcontractor's claim, "the claimant may proceed to enforce his lien * * *" (*ibid.*). The sums due a subcontractor as shown by the itemized statement "shall be a lien" on the construction (Section 44–10, Appendix, *infra,* p. 30), and after notice has been given by the subcontractor, "no payment to the contractor shall be a credit on or a discharge of the lien herein provided for" (Section 44–9, Appendix, *infra,* p. 30). Finally, it is provided that if the owner's indebtedness to the contractor is insufficient to pay the claims of all subcontractors who have given notice, the owner shall distribute the amount owing *pro rata* among the claimants (Section 44–11, Appendix, *infra,* p. 30).

The effect of the foregoing provisions is, as the Court of Appeals stated (R. 34), to give a subcontractor two different methods of obtaining payment of his claim against the contractor. (1) He has a "lien upon the improved real estate" which is extinguished if an action to enforce it is not commenced within six months. (2) He has "an independent cause of action against the owner, maintainable in his own name and in his own right," which he can institute

COPY BOUND CLOSE IN CENTER

within the statutory period of limitations. However, both of these rights come into being only after the subcontractor has given notice to the owner (R. 34; see *supra*, p. 13). Furthermore, his "independent cause of action" against the owner "is dependent upon acquiring a lien on the property by giving the notice to the owner; and if no lien on the property is or can be acquired, no duty or obligation is imposed upon the owner by giving the notice" (*Charlotte Pipe and Foundry Co.* v. *Southern Aluminum Co.*, 172 N.C. 704, 707).[5]

2. The Court of Appeals was of the view that since the North Carolina Supreme Court has described the owner's duty to pay the subcontractor as "an independent and primary obligation created by statute" (*Schnepp* v. *Richardson*, 222 N.C. 228, 229), the contractor's claim against the owner, to the extent that it is subject to reduction by such payment, is no longer part of the property of the contractor. But this conclusion overlooks the crucial fact that in proceeding against the owner the subcontractor is merely seeking to apply the owner's existing debt to the contractor to the satisfaction of his own claim against the latter. For under North Carolina law the owner

[5] The North Carolina statutes themselves refer to the "statutory right to payment" as an action to enforce a lien (see *supra*, pp. 17–18), and the North Carolina Supreme Court regularly has characterized the right of action as based upon a lien (see, *e.g.*, *Morganton Hardware Co.* v. *Morganton Graded Schools*, 151 N.C. 507; *Morganton Mfg. and Trading Co.* v. *Andrews*, 165 N.C. 285; *Charlotte Pipe and Foundry Co.* v. *Southern Aluminum Co.*, 172 N.C. 704; *Norfolk Building Supplies Co.* v. *Elizabeth City Hospital Co.*, 176 N.C. 87).

is liable to the subcontractor "only to the extent of the unexpended contract price still retained by him" (*Schnepp* v. *Richardson, supra*); the legislation was designed to enable subcontractors "to secure, in order to [obtain] the payment of what is due them, the indebtedness due from the debtor to the contractor" (*Lester* v. *Houston,* 101 N.C. 605, 610). It has been repeatedly held that the subcontractor has an enforceable claim against the owner only to the extent of the latter's indebtedness to the contractor at the time that notice is given.[6]

The North Carolina legislation merely provides a procedure by which the subcontractor may satisfy his claim against the contractor directly out of the latter's claim against the owner. But the fact that the state gives the subcontractor such a method of enforcing his lien does not convert the owner's contractual obligation to the contractor into a direct and independent indebtedness to the subcontractor. To the contrary, the very existence of an enforceable claim by the subcontractor against the owner presupposes, and is dependent upon, a valid claim by the contractor for the balance due under the contract. Unless the contractor has such a claim, the subcontractor cannot

[6] *Lester* v. *Houston*, 101 N.C. 605; *Widenhouse* v. *Russ*, 234 N.C. 382; *Schnepp* v. *Richardson*, 222 N.C. 228; *Atlas Powder Co.* v. *Denton*, 176 N.C. 426; *Rose* v. *Davis*, 188 N.C. 355; *Payne* v. *Flack*, 152 N.C. 600; *Pinkston* v. *Young*, 104 N.C. 102; *Clark* v. *Edwards*, 119 N.C. 115; *Orinoco Supply Co.* v. *Eastern Star Home*, 163 N.C. 513. In the typical case, the contractor defaults before completing the work, and the owner's additional expense in finishing the job offsets any balance otherwise due the contractor. See, *e.g.*, *Clark* v. *Edwards* and *Schnepp* v. *Richardson, supra.*

COPY BOUND CLOSE IN CENTER

acquire any rights against the owner by giving notice. Such claim continues to be "property" of the contractor even though state law permits it to be directly applied to the discharge of the latter's debts.

In *United States* v. *Kings County Iron Works,* 224 F. 2d 232 (C.A. 2), the court rejected the contention that, under similar provisions of the New York state lien law, a contractor's claim against an owner ceased to be property of the contractor for federal tax purposes. As the court there pointed out (p. 234), New York provides a "mechanic's lienor with two separate and distinct forms of protection for its claim. One of these is the ordinary lien on the real estate improved by * * * [his] services * * *. The other * * * is an interest in the funds which the owner of the improved real estate owes the prime contractor. These funds are deemed a trust fund for the payment of subcontractors, N.Y. Lien Law §§ 13(7), 36–a, and the trust fund arises when the subcontractor performs his services."

In holding that a federal tax lien had priority over a subsequently filed mechanic's lien against funds due to the contractor from the owner, the Second Circuit rejected the argument that "the trust fund given by these statutory provisions * * * divests the contractor of his property interest in his chose in action against the property owner * * * for federal tax purposes" (p. 235). The court stated (pp. 235–236):

> Until and unless the mechanic's lienor perfects his rights to the trust fund by filing a timely civil action in accordance with § 75 of N.Y. Lien Law, the contractor retains a paramount

> interest in the property in question, so that the debt belongs to him and is subject to federal levy as such.

The court further held (p. 236) that "until such a suit is brought, the fact and the amount of the final mechanic's lien remain uncertain"; and that "for federal tax purposes the state lien is general and inchoate until such time."

The court's reasoning, we submit, is equally applicable to this case. Here, too, the State of North Carolina gives the materialman "two separate and distinct forms of protection" for his claim: the normal lien on the real estate and "an interest in the funds which the owner of the improved real estate owes the prime contractor". But until the subcontractor "perfects his rights" to this fund by giving notice of his claim to the owner and taking the further steps necessary to obtain a choate lien (see *supra*, p. 15), "the contractor retains a paramount interest in the property in question, so that the debt belongs to him and is subject to federal levy as such." See, also, *Aquilino* v. *United States*, 3 N.Y. 2d 511, pending on writ of certiorari, No. 1, this Term, where the New York Court of Appeals similarly held that an owner's indebtedness to a contractor is "property" to which a federal tax attaches; and that such lien has priority over a subsequently created mechanic's lien. The court ruled (3 N.Y. 2d at 516) that "the provision in this state's Lien Law * * * that funds received by a contractor from the owner for the improvement of real property shall be deemed 'trust funds' for the payment of subcontractors * * * may

COPY BOUND CLOSE IN CENTER

not be construed to affect the rights of the government or the priority of its tax lien."[7]

3. Basically, the subcontractors' argument here is but another formulation of the view, repeatedly rejected by this Court, that by the mere existence of an inchoate lien upon a taxpayer's property, "such goods severed themselves from the general and free assets of the * * * [taxpayer] from which the claims of the United States were entitled to priority". *United States* v. *Waddill Co.*, 323 U.S. 353, 358–359. For in any case in which priority is sought for inchoate local liens over existing federal liens, it can always be argued that the effect of the inchoate lien is to remove the assets to which it applies from the taxpayer's property.

Congress, however, has made the decision that in such cases the federal lien has priority. Only four

[7] The reliance of the court below (R. 36–37) upon *Fidelity & Deposit Co.* v. *New York City Housing Auth.*, 241 F. 2d 142 (C.A. 2), is misplaced. There, the taxpayer-contractor breached its contract with the owner— *i.e.*, a special provision requiring payment of the laborers and materialmen as a condition precedent to receipt of any part of the contract price—and the Second Circuit held that accordingly there was no debt due to the taxpayer-contractor and that the taxpayer-contractor had no right to which the federal lien could attach. But it reached that result solely on the ground that, as a matter of state contract law, the taxpayer-contractor had no contractual right to which the federal lien could attach (pp. 144–145). The Second Circuit distinguished its earlier decision in the *Kings County* case, *supra*, on the ground that there it was "not disputed * * * that the taxpayer-contractor * * * was owed money (having performed his promises under a contract) by the owner" (241 F. 2d at 145); and it stated (*ibid.*) that *Kings County* held that for federal tax purposes the "trust fund" created by New York law resulted only in a lien which was junior to the federal tax lien.

categories of lienors are specifically excepted by Section 6323 of the Code (Appendix *infra,* p. 27) from the priority of the federal lien—mortgagees, pledgees, purchasers and judgment creditors—and then only with respect to unrecorded liens. Since the subcontractors' "statutory right to payment" had not been reduced to judgment prior to either the attachment of both federal liens or the recording of one of them, Section 6323 is inapplicable here.[8] The decision below thus elevates the holders of a mere statutory right to payment, not even asserted at the time the federal lien arose, to a status which is not even enjoyed by mortgagees, pledgees, purchasers, and judgment creditors. It is clear, however, that Congress did not "intend * * * antecedent federal tax liens to rank behind any but the specified categories of interests set out" in Section 6323. *United States* v. *New Britain,* 347 U.S. 81, 88.

D. Giving the subcontractors priority would result in extinguishing an existing federal lien through the rejected doctrine of "relation back"

Since the contractor's claim against the owner was "property" of the former, and since the subcontractors had no security interest in that property at the

[8] This Court has made it clear that the four categories of persons entitled to protection under Section 6323 are to be defined according to the conventional meaning of the terms used in the statute. See *United States* v. *Gilbert Associates,* 345 U.S. 361, 364–365 ("judgment creditor"); *United States* v. *Scovil,* 348 U.S. 218, 221 ("purchaser"). See also *United States* v. *Security Tr. & Sav. Bk.,* 340 U.S. 47, 52 (concurring opinion of Mr. Justice Jackson).

COPY BOUND CLOSE IN CENTER

time the federal lien attached, the effect of the decision below is to treat the unperfected lien subsequently created by the giving of notice as relating back to a date prior to the creation of the federal lien. But "the doctrine of relation back * * * [cannot] operate to destroy the realities of the situation." *United States* v. *Security Trust & Savings Bank,* 340 U.S. 47, 50; *New York* v. *Maclay,* 288 U.S. 290, 294. The realities of the situation here are that at the time the federal liens attached, the subcontractors had not yet asserted their "statutory right to payment" by giving notice, and the full balance due under the contract was owing to the contractor. The right to receive such balance was, as we have shown, property of the contractor to which the federal lien attached. Thus, when the inchoate liens in favor of the subcontractors were created by giving notice, the property to which such liens attached was already encumbered by the perfected federal liens. The rights which the subcontractors acquired, therefore, were necessarily subject to the prior rights of the United States. "[S]tate law may not destroy a [federal] tax lien which has attached * * *." *Commissioner* v. *Stern,* 357 U.S. 39, 47.

Thus, however one may characterize the interest of the subcontractors at the time the federal lien attached—whether as inchoate lienors or as the holders of a possible "statutory right to payment" to be asserted against the owners—that interest remains nonetheless subordinate to the tax lien of the United States.

CONCLUSION

The judgment of the Court of Appeals should be reversed, and the order of the referee in bankruptcy should be reinstated.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
DANIEL M. FRIEDMAN,
Assistant to the Solicitor General.
A. F. PRESCOTT,
MYRON C. BAUM,
Attorneys.

AUGUST 1959.

COPY BOUND CLOSE IN CENTER

APPENDIX

Internal Revenue Code of 1954:

SEC. 6321. LIEN FOR TAXES.

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

(26 U.S.C. 1952 ed., Supp. V, Sec. 6321.)

SEC. 6322. PERIOD OF LIEN.

Unless another date is specifically fixed by law, and the lien imposed by section 6321 shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed is satisfied or becomes unenforceable by reason of lapse of time.

(26 U.S.C. 1952 ed., Supp. V, Sec. 6322.)

SEC. 6323. VALIDITY AGAINST MORTGAGEES, PLEDGEES, PURCHASERS, AND JUDGMENT CREDITOR.

(a) *Invalidity of Lien Without Notice.*—Except as otherwise provided in subsection (c), the lien imposed by section 6321 shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the Secretary or his delegate—

(1) *Under State or Territorial Laws.*—In the office designated by the law of the State or Territory in which the property subject to the lien is situated, whenever the State or Territory has by law designated an office within the State or Territory for the filing of such notice; or

(2) *With Clerk of District Court.*—In the office of the clerk of the United States district court for the judicial district in which the property subject to the lien is situated, whenever the State or Territory has not by law designated an office within the State or Territory for the filing of such notice; * * *

* * * * *

(26 U.S.C. 1952 ed., Supp. V, Sec. 6323.)

General Statutes of North Carolina (Recompiled 1950):

SEC. 44–1. *On buildings and property, real and personal.*—Every building built, rebuilt, repaired or improved, together with the necessary lots on which such building is situated, and every lot, farm or vessel, or any kind of property, real or personal, not herein enumerated, shall be subject to a lien for the payment of all debts contracted for work done on the same, or material furnished.

* * * * *

SEC. 44–6. *Lien given subcontractors, etc., on real estate.*—All subcontractors and laborers who are employed to furnish or who do furnish labor or material for the building, repairing or altering any house or other improvement on real estate, have a lien on said house and real estate for the amount of such labor done or material furnished, which lien shall be preferred to the mechanic's lien now provided by law, when notice thereof shall be given as hereinafter provided, which may be enforced as other liens in this chapter, except where it is otherwise provided; but the sum total of all the liens due subcontractors and materialmen shall not exceed the amount due the original contractor at the time of notice given.

* * * * *

COPY BOUND CLOSE IN CENTER

SEC. 44–8. *Statement of contractor's indebtedness to be furnished to owner; effect.*—When any contractor, architect or other person makes a contract for building, altering or repairing any building or vessel, or for the construction or repair of a railroad, with the owner thereof, it is his duty to furnish to the owner or his agent, before receiving any part of the contract price, as it may become due, an itemized statement of the amount owing to any laborer, mechanic or artisan employed by such contractor, architect or other person, or to any person for materials furnished, and upon delivery to the owner or his agent of the itemized statement aforesaid, it is the duty of the owner to retain from the money then due the contractor a sum not exceeding the price contracted for, which will be sufficient to pay such laborer, artisan or mechanic for labor done, or such person for material furnished, which said amount the owner shall pay directly to the laborer, mechanic, artisan or person furnishing materials. The owner may retain in his hands until the contract is completed such sum as may have been agreed on between him and the contractor, architect or other person employing laborers, as a guaranty for the faithful performance of the contract by such contractor. When such contract has been performed by the contractor such fund reserved as a guaranty shall be liable to the payment of the sum due the laborer, mechanic or artisan for labor done, or the person furnishing the materials as hereinbefore provided.

SEC. 44–9. *Subcontractors, laborers, and materialmen may notify owner of claim; effect.*—Any subcontractor, laborer, mechanic, artisan, or person furnishng materials, who claims the lien provided for in this article for labor on, or materials furnished for, any building, vessel, railroad, or real estate, may give notice to the owner, agent or lessee who makes the contract

for the labor or materials, of the amount due by the contractor to such claimant. The notice shall be in the form of an itemized statement of the amount due, except where the contract is entire for a gross sum and cannot be itemized. Upon the delivery of the notice to the owner, agent, or lessee, the claimant is entitled to all the liens and benefits conferred by law in as full a manner as though the statement were furnished by the contractor. If the said owner, agent or lessee refuses or neglects to retain, out of the amount due the contractor under the contract, a sum not exceeding the price contracted for which will be sufficient to pay such claimant, then the claimant may proceed to enforce his lien, and after such notice is given no payment to the contractor shall be a credit on or a discharge of the lien herein provided for.

SEC. 44–10. *Sums due by statement to constitute lien.*—The sums due to the laborer, mechanic or artisan for labor done, or due the person furnishing materials, as shown in the itemized statement rendered to the owner, shall be a lien on the building, vessel or railroad built, altered or repaired, without any lien being filed before a justice of the peace or the superior court.

SEC. 44–11. *Where sums due contractor from owner insufficient; payment pro rata.*—If the amount due the contractor by the owner is insufficient to pay in full the laborer, mechanic or artisan, for his labor, and the person furnishing materials, for materials furnished, it is the duty of the owner to distribute the amount pro rata among the several claimants, as shown by the itemized statement furnished the owner, or of which notice has been given the owner by the claimant.

* * * * *

SEC. 44–12. *Contractor failing to furnish statement, or not applying owner's payments to laborer's claims, misdemeanor.*—If any contrac-

COPY BOUND CLOSE IN CENTER

tor or architect shall fail to furnish to the owner an itemized statement of the sums due to every one of the laborers, mechanics or artisans employed by him, or the amount due for materials, before receiving any part of the contract price, he shall be guilty of a misdemeanor. If any contractor shall fail to apply the contract price paid him by the owner or his agent to the payment of bills for labor and material, he shall be guilty of a misdemeanor and upon conviction thereof shall be fined or imprisoned, or both, at the discretion of the court.

* * * * *

SEC. 44–38. *Claim of lien to be filed; place of filing.*—All claims against personal property, of two hundred dollars and under, may be filed in the office of the nearest justice of the peace; if over two hundred dollars or against any real estate or interest therein, in the office of the superior court clerk in any county where the labor has been performed or the materials furnished; but all claims shall be filed in detail, specifying the materials furnished or labor performed, and the time thereof. If the parties interested make a special contract for such labor performed, or if such material and labor are specified in writing, in such cases it shall be decided agreeably to the terms of the contract, provided the terms of such contract do not affect the lien for such labor performed or materials furnished.

SEC. 44–39. *Time of filing notice.*—Notice of lien shall be filed as hereinbefore provided, except in those cases where a shorter time is prescribed, at any time within six months after the completion of the labor or the final furnishing of the materials, or the gathering of the crops.

* * * * *

SEC. 44–40. *Date of filing fixes priority.*—The liens created and established by this chapter shall be paid and settled according to the prior-

ity of the notice of the lien filed with the justice or the clerk.

* * * * *

SEC. 44–43. *Action to enforce lien.*—Action to enforce the lien created must be commenced in the court of a justice of the peace, and in the superior court, according to the jurisdiction thereof, within six months from the date of filing the notice of the lien. But if the debt is not due within six months, but becomes due within twelve months, suit may be brought or other proceedings instituted to enforce the lien in thirty days after it is due.

SEC. 44–48. *Discharge of liens.*—All liens created by this chapter may be discharged as follows:

* * * * *

4. By a failure of the claimant to commence an action for the enforcement of the lien within six months from the notice of lien filed.

U.S. GOVERNMENT PRINTING OFFICE: 1939

COPY BOUND CLOSE IN CENTER